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AGENDA ITEM 8b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Trading Process Modifications

II. PROGRAM: Global Equity

III. RECOMMENDATION: Information

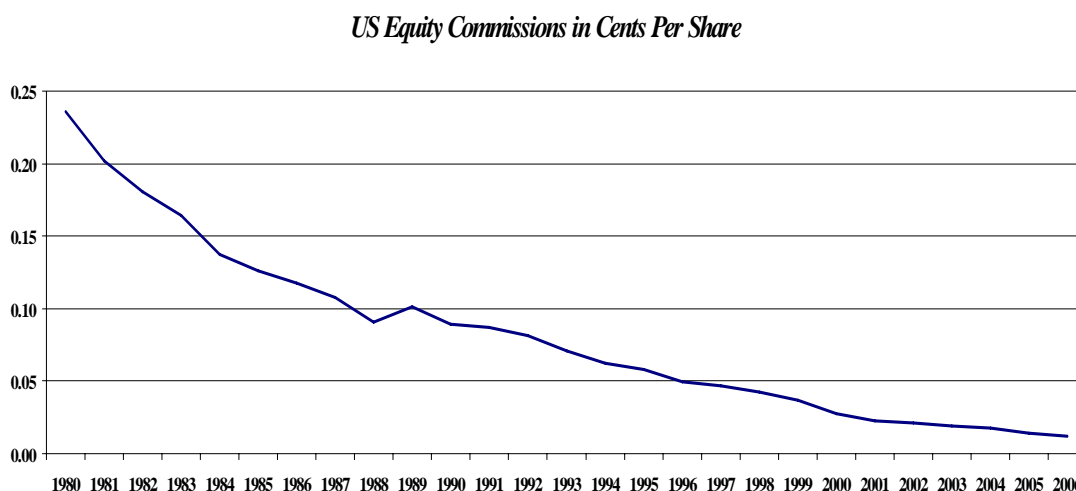
IV. ANALYSIS:

Introduction

CalPERS' internal equity management team, in the course of managing both domestic and international portfolios, engages in a large amount of trading activity as measured by both the number of trades and the dollar value of trades. This trading volume generates a large amount of brokerage commissions. Two goals have historically been at the forefront of the process: achieving best execution and providing opportunity to a diverse set of counterparties, including emerging brokerage firms. While, execution results have been very good, the ability to trade with all potential counterparties interested in doing business with CalPERS has been more difficult. The continually declining per share commission charges is a major challenge (Figure 1) which can reduce the value of the CalPERS relationship with some counterparties and create significant economic hurdles for emerging firms. In addition, as the current number of counterparties has grown, the system for selecting brokers has become exceedingly complex and difficult to administer.

Accordingly, staff engaged Mosaic Investment Advisors, one of CalPERS' diversity consultants, to assist in a review of the current process for internal equity brokerage allocation with the objective of accomplishing best execution, increasing the opportunity to include a diverse set of counterparties, and developing a transparent process.

Figure 1



The Data Collection Process

Beginning in the fourth quarter of 2007, CalPERS staff and Mosaic developed a self-administered survey that measured the three elements that were considered to be the most critical for evaluating the desirability of a broker relationship:

- Execution Quality – the quantitative results of execution prices, net of commission, versus the target price
- Operational Capability – the broker's ability to receive, process, and settle trades in a robust and efficient manner
- Value-added – the number and quality of particular, often proprietary, items that a broker can provide that will assist staff in the managing of the portfolio. These items can include research of various types, specific analytical software, access to new equity offerings, and the ability to commit capital, if needed.

Staff also worked with Mosaic to develop a list of brokers who should receive the survey including current business relationships as well as emerging brokers who did not have a current business relationship with CalPERS but could have an interest in being added to the counterparty list. The emerging brokers were drawn from several sources: firms that were known to staff, firms that were known to Mosaic, and firms on various lists, such as the one compiled by Altura Capital Group.

The questionnaire was sent to brokers in early January with follow-up phone calls by both staff and Mosaic to encourage firms to respond. In all, 130 firms were sent questionnaires with 67 responses received.

Broker Evaluation and Selection Methodology

Upon compiling data both from the questionnaire responses as well as from live trading for current CalPERS brokers, staff from CalPERS and Mosaic worked collaboratively to devise the following methodology for addressing: 1) brokers with whom live results exist, and 2) potential new relationships.

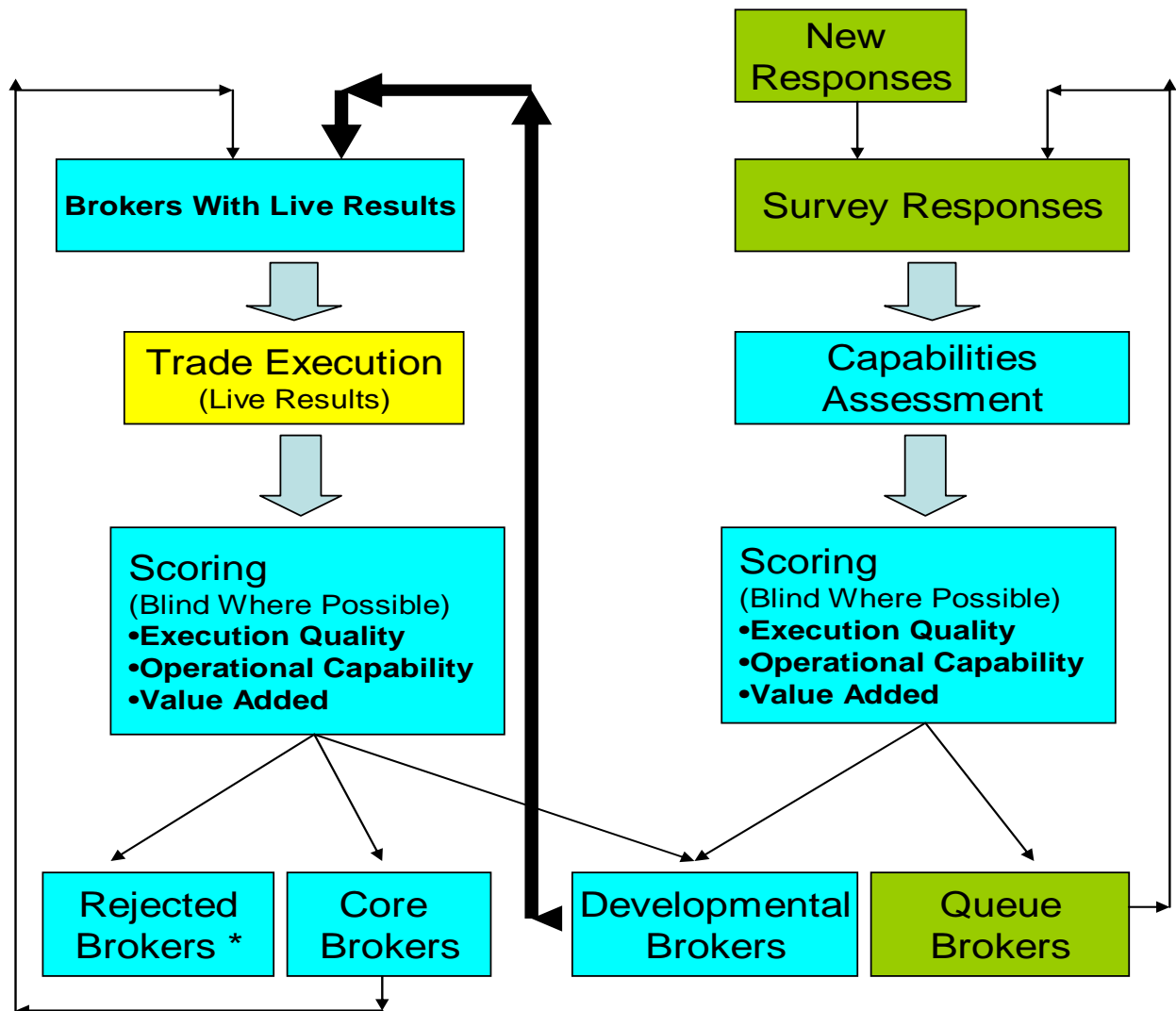
For executing brokers with whom live results exist, the evaluation methodology to be adopted begins with determining the Execution Quality score for each active counterparty. Of the current roster, 20% are contained within the emerging category. Using Execution Quality as a first screen not only reinforces its importance for the overall process but affords objectivity and transparency. CalPERS staff and the diversity consultant then collaborate to jointly score (on a blind basis where possible) the counterparty with respect to Operational Capability and Value Added, yielding a final, aggregate score. With these aggregate scores, brokers are then categorized as “Core” (have met / exceeded expectations and with whom there can be a material, mutually-beneficial relationship), “Developmental” (under evaluation to determine capability and utility of product offering), and “Rejected” (results that fall short of expectations).

For new potential relationships, and indeed for all relationships, the selection methodology begins with the broker completing the survey. Survey responses are then jointly reviewed by CalPERS staff and the diversity consultant in an effort to assess the capabilities of the broker in question. This portion of the process is also performed on a blind basis where possible. The purpose of employing blind scoring is to ensure that while the process is transparent, the broker identities are concealed and the evaluations themselves are confidential to eliminate any rater bias and potential outside influence. Upon determining survey scores for each of the responses, brokers are then either placed into the “Developmental” category or placed on the Queue (a list, maintained by Mosaic, of brokers desiring to do business with CalPERS). Brokers on the Queue will automatically be considered when the process is repeated.

Lastly there is a staff and diversity consultant review of the process outcome as a way to ensure that the results make sense. To the extent that the review cannot reconcile the outcome with what would appear to be the optimal result, the process will be examined and modified as appropriate. Brokers who are classified as Queue brokers and those who are rejected will receive an evaluation of why they were not selected.

Figure 2 below depicts the overall process and flow for broker evaluation and selection.

Figure 2
Broker Evaluation Process



* Eligible to re-enter survey process

Portion of the process managed by Mosaic

Portion of the process managed by CalPERS Staff

Portion of the process managed jointly by Mosaic and CalPERS Staff

Conclusion

In light of changes both in the marketplace in general and at CalPERS specifically, the current brokerage model employed by internal equity staff is in need of an update. Falling commissions and a large list of brokers desiring to do business with CalPERS has resulted in Internal Equity staff having a very large number of brokers pursuing CalPERS' business. Further, as both the marketplace and CalPERS have become more reliant on technology-oriented trading capabilities, there has been (and continues to be) consolidation and a dramatic shift in counterparties able to provide competitive execution. The process for providing access to emerging counterparties, needs to be both objective and transparent.

As a result, staff has conducted a thorough review of current practices and industry best-practices and has engaged Mosaic, one of CalPERS' diversity consultants. Staff therefore proposes a model wherein all brokers are evaluated based on the criteria of execution quality, operational capability, and value added. Based on the objective, quantitative scores achieved in these three areas, brokers will be placed into one of three "pools": Core, Developmental, and Queue. Counterparties in the Core pool will be those that have a high aggregate score and therefore provide a great deal of utility for CalPERS, while those in the Developmental group will be provided an opportunity to demonstrate their capabilities and advance into the core group as warranted.

As brokers enter and leave the Core and Developmental groups, opportunity will be created for those in the Queue to move to the Developmental group so that their capabilities can be demonstrated. Once the Core and Developmental pool concept is implemented, staff will be working with a much smaller set of brokers, allowing a more informed evaluation of capabilities as well as more meaningful and leverageable relationships. Further, throughout this ongoing process, staff will continue to work with the diversity consultant to ensure that appropriate opportunities are being provided and that transparency in the process is maintained.

Attached is a Wilshire opinion letter (Attachment 1)

V. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The only new cost of the proposed revised process will be the ongoing cost of the engagement of the diversity consultant estimated at \$200,000 per year. The benefits as a result of leveraging trading activity in addition to creating opportunity and transparency in terms of targeted brokerage are expected to more than outweigh the costs.

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